

Message Text

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ACTION TRSE-00

INFO OCT-01 EUR-12 EA-06 ISO-00 SP-02 AID-05 EB-07 NSC-05

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USMISSION EC BRUSSELS

AMEMBASSY LONDON

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PASS TREASURY FOR SYVRUD

E.O. 11652: N/A

TAGS: EFIN, ECON, IT

SUBJECT: MEDIUM-TERM OUTLOOK

REF: STATE 136051 (NOTAL)

1. SUMMARY. GOI IS PLACING STRONG EMPHASIS ON EXPORT-LED ECONOMIC RECOVERY. RELATIVELY LARGE FOREIGN SECTOR, PAST HISTORY OF GOOD EXPORT PERFORMANCE AND EXPORT-LED GROWTH, PLUS DEFICIENCIES IN OTHER ITALIAN TOOLS OF ECONOMIC MANAGEMENT EXPLAIN THIS GOI POSITION. WHILE CLOSER SYNCHRONIZATION OF ITALIAN BUSINESS CYCLE WITH THAT OF OTHER MAJOR INDUSTRIAL COUNTRIES IS PROBABLE OVER MEDIUM-TERM, ON BALANCE WE WOULD STILL EXPECT THAT IMPORTANT DIFFERENCES IN STAGE OF DEVELOPMENT AND IN PERFORMANCE OF ITALIAN ECONOMY WILL KEEP ITALY

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SOMEWHAT OUT-OF-PHASE WITH AT LEAST SOME OF OTHER MAJOR COUN-

TRIES. END SUMMARY.

2. GENERAL CONSIDERATION. LATEST EMBASSY QUARTERLY ECONOMIC FORECAST FOR ITALY TRANSMITTED DIRECTLY TO TREASURY AND OTHER INTERESTED WASHINGTON AGENCIES AT END-MARCH HAD ALREADY RAISED QUESTION AS TO WHETHER ITALY, SPECIFICALLY, AND INDUSTRIAL COUNTRIES IN GENERAL WERE HEADED FOR PERIOD OF SYNCHRONIZED BOOMS AND BUSTS. OUR ROUGH PROJECTION OF ITALIAN DEFICIT ON GOODS AND SERVICES DURING FIRST HALF 1976 FOLLOWING ON PRE-SUMED ECONOMIC RECOVERY SHOWED RATHER LARGE NEGATIVE FIGURE. WHILE WE DO NOT HAVE GREAT CONFIDENCE IN THAT ESTIMATE AND ARE NOW UPDATING OUR FORECASTS, THE DEFICIT DID RAISE QUESTION AS TO WHETHER ITALIAN ECONOMY MAY BE FACED IN COMING YEARS WITH MORE RESTRICTIVE BALANCE OF PAYMENTS CONSTRAINT THAN HAS HERETOFORE BEEN THE CASE. ARGUMENTS CAN BE MADE IN EITHER DIRECTION. ON ONE HAND, ITALIAN EXPORT PERFORMANCE HAS TRADITIONALLY BEEN GOOD, ALTHOUGH RISING REAL LABOR COSTS IN RECENT YEARS ARE WORRISOME. ON OTHER HAND, DEPENDENCE OF ITALIAN ECONOMY ON GROWTH OF FOREIGN TRADE AND PARTICULARLY HIGH DEPENDENCE ON IMPORTS OF FOOD, RAW MATERIALS AND PETROLEUM RAISE QUESTIONS ABOUT FUTURE STRENGTH OF BALANCE OF PAYMENTS. OVERSTIMULATION OF GROWTH RESULTING IN SYNCHRONIZED BOOM IN INDUSTRIAL WORLD WITH REPETITION OF SHARP RISES IN COMMODITY PRICES WOULD AGAIN SHARPLY WORSEN ITALY'S TERMS OF TRADE AND COULD LIMIT GROWTH OF GNP TO UNACCEPTABLE LEVEL.

3. INCREASINGLY CLOSE ECONOMIC RELATIONSHIPS AMONG WESTERN EUROPE, US AND JAPAN MAY IMPLY MORE CLOSELY COINCIDENT MOVEMENT IN PATTERN OF GROWTH IN THESE COUNTRIES. ON OTHER HAND, STAGE OF DEVELOPMENT, SIZE OF ECONOMIES, RELATIVE SIZE OF FOREIGN SECTOR AND AVAILABILITY AND EFFECTIVENESS OF DIFFERENT TOOLS OF ECONOMIC MANAGEMENT STILL DIFFER SIGNIFICANTLY AMONG MAJOR INDUSTRIAL ECONOMIES. BECAUSE ITALY'S ECONOMY IS AT RELATIVELY LOWER STAGE OF DEVELOPMENT THAN THAT OF MOST OTHER INDUSTRIAL COUNTRIES, ITALY MAY MORE LIKELY BE "ODD MAN OUT" IN TERMS OF BUSINESS CYCLE PHASES THAN SOME OTHER COUNTRIES. IN FACT, IN RECENT YEARS ITALIAN BUSINESS CYCLE HAS BEEN OUT-OF-PHASE WITH THAT OF OTHER INDUSTRIAL ECONOMIES, ALTHOUGH EARLY STAGE OF LATEST ITALIAN BOOM OVERLAPPED WITH LATTER STAGES OF BOOM IN MOST OTHER COUNTRIES.

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4. IT IS DIFFICULT TO DRAW ANY CLEAR CONCLUSION AS TO RELATIVE PROBABILITY OF SYNCHRONIZED BUSINESS CYCLES. ON BALANCE, WE TEND TO THINK THAT ITALIAN CYCLE WILL FOLLOW THAT OF OTHER INDUSTRIAL COUNTRIES SOMEWHAT MORE CLOSELY THAN HERETOFORE, BUT THAT ITALIAN ECONOMY WILL NOT NECESSARILY MOVE IN RIGID PATTERN WITH THAT OF OTHER MAJOR INDUSTRIAL COUNTRIES, AT LEAST OVER NEXT FEW YEARS.

5. THE PATTERN THAT MAY EMERGE COULD BE (1) EXPORT-LED RECOVERY FOLLOWING AN UPSWING IN WESTERN EUROPE AND (2) REPETITION OF 1973-1974 CRUNCH AS UNIT IMPORT COSTS TEND TO RISE WITH WORLDWIDE EXPANSION, FOLLOWED BY SOFTENING OF EXPORT MARKETS AS WORLD ECONOMY COOLS DOWN. THIS WOULD MAKE THE ITALIAN ECONOMY THE TAIL OF THE WORLD ECONOMIC KITE. ITALY IS WORKING HARD WITH SOME SUCCESS IN DEVELOPING EASTERN EUROPEAN AND OPEC EXPORT MARKETS TO LESSEN SOMEWHAT DEPENDENCE ON EC-SWITZERLAND-US MARKETS, WHICH SEEM INCREASINGLY TO MOVE TOGETHER.

6. ITALIAN POLICY RESPONSE OVER MEDIUM-TERM. THERE IS NO DOUBT THAT ITALIAN ECONOMIC POLICY AIMS AT A RECOVERY IN GROWTH AND EMPLOYMENT OVER NEXT YEAR OR SO ON BASIS OF RESURGENCE OF EXPORTS TO ITALY'S MAIN TRADING PARTNERS, PARTICULARLY GERMANY, OPEC COUNTRIES AND, TO LESSER EXTENT, US. ITALIAN FOREIGN SECTOR IS IMPORTANT PART OF OVERALL ECONOMY, WITH EXPORTS EQUAL TO 23.7 PERCENT OF GDP AND IMPORTS EQUAL TO 29.8 PERCENT OF (CURRENT LIRE) GDP IN 1974. FOR EXAMPLE, DIFFERENCE BETWEEN 5 PERCENT RATE OF GROWTH IN EXPORTS (CURRENT LIRE) IN 1975 AND 10 PERCENT RATE OF GROWTH WOULD REPRESENT DIFFERENCE OF 1.2 PERCENT IN GROWTH OF GDP. WE DO NOT BELIEVE THAT GOI AUTHORITIES HAVE MADE SPECIFIC CALCULATION OF VALUE TO ITALY OF 1 PERCENT RISE IN US GNP, BUT IT IS CLEAR FROM POLICY STATEMENTS THAT THEY CONSIDER ECONOMIC RECOVERY IN US TO BE EXTREMELY IMPORTANT TO ITALIAN RECOVERY. APART FROM FACT THAT FOREIGN SECTOR IS IMPORTANT AND THAT ITALY HAS BENEFITTED FROM EXPORT-LED GROWTH IN PAST, RELIANCE ON EXPORT GROWTH ALSO REFLECTS GOI DOUBTS ABOUT THE EFFICIENCY OF ITALIAN DEMAND MANAGEMENT TOOLS IN STIMULATING DOMESTIC DEMAND AS AN ALTERNATIVE SOURCE OF ECONOMIC RECOVERY.

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INFO OCT-01 EUR-12 EA-06 ISO-00 SP-02 AID-05 EB-07 NSC-05

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7. BECAUSE ITALIAN BUSINESS CYCLE LAGGED THAT OF MOST OTHER COUNTRIES, ITALY HAD REASONABLY GOOD RATE OF GROWTH LAST YEAR (3.4 PERCENT), EVEN THOUGH LAST QUARTER SHOWED SHARP DECLINE IN ECONOMIC ACTIVITY. SINCE ECONOMIC DOWNTURN IS STILL FAIRLY RECENT, GOI AUTHORITIES MAY BE ABLE TO WAIT FOR SOME MONTHS YET IN HOPE THAT ECONOMIC RECOVERY ABROAD WILL STIMULATE EXPORTS, WITHOUT BEING TEMPTED TO RESORT TO EXCESSIVE REFLATIONARY POLICIES TO STIMULATE DOMESTIC DEMAND. THIS DELIBERATE POLICY COULD BE ERODED IF UPTURN DOES NOT BEGIN BY END-1975 OR EARLY 1976. SOME CUT IN TAX BURDEN THIS FALL IS ALREADY BEING CONTEMPLATED TO REDUCE "FISCAL DRAG" AND TO SUPPLEMENT CURRENT EASING OF MONETARY POLICY.

8. RANGE OF ACCEPTABLE ECONOMIC PERFORMANCE. CURRENT FORECASTS FOR ITALIAN ECONOMIC GROWTH IN 1975 ARE IN RANGE OF LIMITED OFFICIAL USE

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NEGATIVE 1.5 TO 2.5 PERCENT. THIS WOULD CLEARLY BE WORST PERFORMANCE IN AT LEAST LAST 25 YEARS. (PREVIOUS WORST PERFORMANCE WAS 1.6 PERCENT POSITIVE GROWTH RATE IN 1971.) WHILE ITALIAN POLITICAL AND ECONOMIC SYSTEM MAY BE ABLE TO ABSORB EFFECTS OF NEGATIVE GROWTH IN 1975, WE WOULD EXPECT MORE SERIOUS POLITICAL AND ECONOMIC DIFFICULTIES IF GROWTH RATE DOES NOT TURN POSITIVE IN 1976. IN FACT, WE EXPECT THAT ITALIAN AUTHORITIES WOULD BE DISAPPOINTED IF 1976 GROWTH RATE WERE NOT AT LEAST A POSITIVE 2 TO 3 PERCENT. GROWTH RATE FOR 1977 AND FOR MEDIUM-TERM OF ABOUT 5 PERCENT MIGHT APPROXIMATE GOI TARGET FIGURE. (WE ARE NOT AWARE OF ANY CURRENTLY VALID MEDIUM-TERM GROWTH PROJECTIONS EITHER BY GOI OR BY PRIVATE ITALIAN BODIES. OUR SOURCES AT THE BANK OF ITALY, TREASURY AND CONFINDUSTRIA TELL US THAT PAST FORECASTS ARE OUT OF DATE AND SITUATION HAS TOO MANY UNCERTAINTIES TO MAKE MEDIUM-TERM FORECASTING WORTHWHILE. THEY PLAN TO WAIT UNTIL PROSPECTS ARE CLEARER; PERHAPS THIS FALL.)

9. UNEMPLOYMENT IN ITALY TYPICALLY LAGS BEHIND LEVEL OF ECONOMIC ACTIVITY. ITALIAN SYSTEM PROVIDES FOR SIGNIFICANT CUSHION AGAINST OUTRIGHT LAY-OFFS, PARTICULARLY THROUGH IMPLEMENTATION OF THE WAGE SUPPLEMENT FUND AND SHORT-TERM WORK. SHORT-TIME BENEFITS UNDER THE WAGE SUPPLEMENT FUND ARE QUITE GENEROUS SO THAT PURCHASING POWER IS REASONABLY WELL PROTECTED. IN EVENT THAT FUNDS AVAILABLE IN FUND WERE EXHAUSTED, WE WOULD EXPECT GOI TO TAKE WHATEVER STEPS MIGHT BE NECESSARY TO ASSURE ADDITIONAL FINANCING IN ORDER TO AVOID SIGNIFICANT RISE IN UNEMPLOYMENT. OUR END-MARCH (PESSIMISTIC) ESTIMATES SHOWED PEAK UNEMPLOYMENT RATE OF 7.5 PERCENT AT MID-1975 (INCLUDING BOTH UNEMPLOYMENT AND UNDEREMPLOYMENT, WITH LATTER DEFINED AS WORK WEEK OF LESS THAN 33 HOURS). ALTHOUGH HIGH BY ITALIAN STANDARDS, THIS WOULD SEEM TO BE TOLERABLE FIGURE. OUR COMPARABLE ESTIMATE FOR MID-1976 WAS FOR DECLINE IN UNEMPLOYMENT/UNDEREMPLOYMENT RATE TO ABOUT 6.7 PERCENT. WE WOULD ASSUME THAT ECONOMIC RECOVERY WOULD CONTINUE AT LEAST THROUGH 1977, FURTHER REDUCING UNEMPLOYMENT RATE. OVER MEDIUM-TERM, AND ON BASIS PAST HISTORY, WE THINK THAT GOI WOULD AIM FOR MAXIMUM UNEMPLOYMENT/UNDEREMPLOYMENT RATE OF ABOUT 4.25 PERCENT.

10. ITALIAN PRICE PERFORMANCE, ALTHOUGH IMPROVED IN LAST SIX MONTHS OR SO, STILL SHOWS RATHER HIGH CURRENT RATE OF INCREASE. LIMITED OFFICIAL USE

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AVERAGE MONTHLY CONSUMER PRICE RISE AT ANNUAL RATE DURING FIRST FOUR MONTHS OF THIS YEAR WAS 12.6 PERCENT AND COST-OF-LIVING RATE WAS 11.7 PERCENT. (APRIL/APRIL RISES WERE 20.4 AND 21.2 RESPECTIVELY.) ESTIMATES FOR AVERAGE INCREASE THIS YEAR OVER 1974 FOR CONSUMER PRICES ARE MAINLY IN RANGE 17 TO 18 PERCENT (PARTLY BECAUSE OF LOW BASE IN 1974). WE BELIEVE THAT PRICE INCREASES OF THIS SIZE IN 1975 AND EVEN CURRENT RATES OF INCREASE OF 12-13 PERCENT WOULD REPRESENT UNACCEPTABLE FIGURE FOR GOI OVER MEDIUM-TERM. RECENT COMMODITY PRICE BOOM AND PETROLEUM PRICE RISE ACCOUNT FOR SIGNIFICANT PART OF POOR ITALIAN PRICE PERFORMANCE IN 1973-1974. HOWEVER, CONTINUED COST-PUSH FROM LARGE WAGE INCREASES IS ANOTHER IMPORTANT FACTOR WHICH WOULD LIMIT ITALY'S PROSPECTS FOR RETURN TO MORE ACCEPTABLE PRICE PERFORMANCE OVER NEXT FEW YEARS. AS ROUGH GUESS, REASONABLE FIGURE FOR 1976 MIGHT BE IN RANGE 7 TO 9 PERCENT, AND 1977 AND MEDIUM-TERM GOAL MIGHT BE IN RANGE OF 4-5 PERCENT.

11. IN MEDIUM-TERM ITALY MUST, OF COURSE, ACHIEVE BALANCE IN ITS FOREIGN ACCOUNTS, AND SHOULD EVEN AIM AT SOME SURPLUS IF IT IS TO REDUCE RATHER HIGH LEVEL OF FOREIGN DEBT ACCUMULATED IN PERIOD 1973-1975. IN PARTICULAR, TRADE ACCOUNT SURPLUS WILL BE NECESSARY TO OFFSET IN REAL TERMS LARGER PETROLEUM DEFICIT WHICH APPEARS TO BE PERMANENT PART OF ITALIAN BALANCE OF PAYMENTS SITUATION. ELIMINATION OR REDUCTION OF PERSISTENT CAPI-

TAL ACCOUNT DEFICITS WOULD ALSO BE DESIRABLE, BUT PROBABLY
DIFFICULT TO ACHIEVE. CONSEQUENTLY, MAIN BURDEN WILL FALL ON
EXPORT GROWTH. THIS MEANS THAT LABOR COST INFLATION MUST BE
REDUCED AND LIRA EXCHANGE RATE MUST BE ALLOWED TO HELP COM-
PENSATE FOR NAY DEFICIENCIES IN DOMESTIC PRICE PERFORMANCE.
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